Interest and Penalties for Taxpayers Affected by Natural Disasters Are Not Always Prevented or Abated

September 2003

Reference Number: 2003-10-218

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

INSPECTOR GENERAL
for TAX
ADMINISTRATION

September 29, 2003

MEMORANDUM FOR COMMISSIONER, SMALL BUSINESS/SELF-EMPLOYED DIVISION

Gordon C. Milbourn III

FROM: Gordon C. Milbourn III
Assistant Inspector General for Audit (Small Business and Corporate Programs)

SUBJECT: Final Audit Report - Interest and Penalties for Taxpayers Affected by Natural Disasters Are Not Always Prevented or Abated (Audit # 200310009)

This report presents the results of our review of Internal Revenue Service (IRS) actions to provide tax relief to individual taxpayers affected by natural disasters. The overall objective of this review was to determine the effectiveness of IRS actions to prevent or abate interest and penalty assessments for individual taxpayers granted filing and payment extensions in Presidentially declared disaster areas.

The IRS has the authority to grant extensions to file returns and pay taxes for taxpayers located in disaster areas. For disasters occurring before September 11, 2001, where the President also declared a Federal disaster for the area, Internal Revenue Code (I.R.C.) Section (§) 6404(h)[1] required the IRS to abate any interest that would otherwise accrue for the disaster extension period.[2] To provide this tax relief, the IRS developed a computer application to identify affected taxpayers who reside in these disaster areas, based on their zip codes. The programming prevents interest and penalties from accruing, suppresses the issuance of certain notices, and causes a disaster indicator to be placed on affected taxpayers' accounts during the disaster period. Otherwise, interest and penalties would be assessed and then later abated after it was determined that the taxpayer was affected by the disaster.

In summary, many taxpayers residing in the Federal disaster areas we reviewed were not provided the disaster relief that IRS management intended. We identified seven

[1] I.R.C. § 6404(h) (2001).
[2] For disasters occurring on or after September 11, 2001, the authority to suspend interest and penalties for the disaster extension period was added to I.R.C. § 7508A (2002).

disasters where the IRS granted an extension that included April 16, 2001.[3] We analyzed a statistical sample of 461 individual taxpayer accounts coded for these disasters where there were assessments of penalties and interest and the taxpayer had filed after April 16, 2001. In 107 of these 461 accounts, taxpayers did not receive the interest and penalty relief they were entitled to, and interest assessments or accruals totaling $13,766 had not been abated in accordance with I.R.C. § 6404(h). Based on the total population of 170,009 taxpayer accounts with assessments of interest and/or penalties that were coded for relief for the 7 disasters, we estimate that $5.1 million in interest was incorrectly assessed or accrued on 39,460 taxpayer accounts and should be abated. Inappropriate Failure to File (FTF) and/or Failure to Pay (FTP) penalties[4] totaling $15,123 were reflected on 84[5] of the 461 taxpayer accounts. Based on the total population of 170,009 taxpayer accounts coded for relief for the 7 disasters, we estimate that $3.3 million in FTF penalties were inappropriately assessed on 11,063 taxpayer accounts, and $2.3 million in FTP penalties were inappropriately assessed or accrued on 28,765 taxpayer accounts.

We determined that in most of these accounts, interest and/or penalty assessments and accruals were not accurate because the incorrect disaster period beginning or ending dates were input. This occurred because the IRS' Modernization, Information Technology and Security (MITS) Services computer programmers used the IRS disaster declaration memoranda[6] to determine which dates to input; however, the memoranda did not clearly identify the dates for which IRS management intended to suspend interest and penalties on taxpayers' accounts. As a result, the computer programmers input incorrect disaster period beginning dates or ending dates. MITS Services programmers advised that sometime after the period covered by our review, they began informally requiring an e-mail from the National Disaster Assistance Program Manager that specifically details the disaster period beginning and ending dates that IRS management wants input for the disaster coding.

To prevent input errors in the future, we recommended that Small Business/Self-Employed (SB/SE) Division management formalize the practice of providing MITS Services programmers with the specific disaster period beginning and ending dates for input to the disaster program, and that SB/SE Division Compliance Policy management develop procedures to test disaster programming output to ensure that the program is working as management intended. In addition, for the seven disasters reviewed in this

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[3] April 15, 2001, fell on a Sunday, so the original filing due date was extended to Monday, April 16, 2001.
[4] I.R.C. § 6651(a)(1) (2001), commonly referred to as the Failure to File penalty, is imposed when a taxpayer does not file his or her return by the due date, including any extensions. I.R.C. § 6651(a)(2) (2001), commonly referred to as the Failure to Pay penalty, is imposed when any tax due on a return is not paid by the due date of the return.
[5] Eighty-two of these 84 accounts also incurred inappropriate interest assessments or accruals and are included in the 107 accounts previously identified. The remaining two accounts have inappropriate assessments of the FTF penalty only.
[6] The declaration memoranda are addressed to all IRS employees and provide an overview of and guidance for the relief granted to taxpayers.

audit, SB/SE Division management should identify taxpayer accounts where the disaster extension was intended but not provided, and take appropriate action to abate or refund interest and penalties assessed, or to correct interest and penalty accruals on the accounts.

Management's Response: SB/SE Division management agreed with our recommendations. SB/SE Division management advised that since the Disaster Assistance and Emergency Relief Program was transferred to the SB/SE Division in October 2002, all disaster relief memoranda contain the specific beginning and ending dates for filing and payment relief and are distributed to each operating division, including MITS Services. SB/SE Division Disaster Assistance Program management has procedures in place to test programming prior to Master File input and will develop a process to test the output programming to ensure taxpayers receive the relief intended.[7] In addition, SB/SE Division Compliance function management has initiated steps to identify affected taxpayers for the seven disasters included in this review and plans to take actions to correct the taxpayers' accounts and issue refunds, if appropriate. Management's complete response to the draft report is included as Appendix VI.

Copies of this report are also being sent to the IRS managers who are affected by the report recommendations. Please contact me at (202) 622-6510 if you have questions or Daniel R. Devlin, Assistant Inspector General for Audit (Headquarters Operations and Exempt Organizations Programs), at (202) 622-8500.

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[7] The Master File is the IRS database that stores various types of taxpayer account information. This database includes individual, business, and employee plans and exempt organizations data.

Table of Contents

Interest and Penalties for Taxpayers Affected by Natural Disasters Are Not Always Prevented or Abated

Background

Natural disasters, such as floods or hurricanes, generally affect a limited number of taxpayers in a concentrated geographical area, but they can have devastating effects on taxpayers both emotionally and financially. The Internal Revenue Code (I.R.C.) authorizes the Internal Revenue Service (IRS) to grant extensions to file tax returns and pay taxes, to waive penalties, and to abate interest in certain circumstances, including natural disasters. Although not legally required to, the IRS can use its authority under I.R.C. Sections (§§) 6081 and 6161[1] to postpone the deadlines for filing tax returns and paying taxes for taxpayers who live in natural disaster areas. For disasters occurring before September 11, 2001, if the President of the United States declared an area a Federal disaster area,[2] and if the IRS exercised its authority under I.R.C. §§ 6081 and 6161, then I.R.C. § 6404(h)[3] required that the IRS abate any interest that would accrue during the extension period for affected taxpayers.[4]

To provide this tax relief, the IRS developed a computer application to identify affected taxpayers who reside in these disaster areas, based on their zip codes. The IRS uses special transaction codes that mark taxpayers' accounts for disaster processing. The disaster information posted to taxpayers' accounts includes the disaster period beginning date, the disaster period ending date, and the unique four-digit Federal Emergency Management Agency (FEMA) Contract Number. These disaster codes prevent interest and penalties from accruing, suppress the issuance of certain notices, and cause an indicator to be placed on affected taxpayers' accounts during the disaster period. The purpose of the indicator is to alert IRS employees to the taxpayers' disaster status.

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[1] I.R.C. Sections (§§) 6081 (2001) and 6161 (2001).
[2] The President may declare an area as a major disaster or emergency area to provide Federal assistance. Disaster areas and emergency areas receive different levels of Federal assistance. The Federal Emergency Management Agency is responsible for Federal disaster relief activities.
[3] I.R.C. § 6404(h) (2001).
[4] For disasters occurring on or after September 11, 2001, the authority to suspend interest and penalties for the disaster extension period was added to I.R.C. § 7508A (2002).

For individual taxpayer accounts, if the taxpayer's original filing and payment due dates fall within the disaster tax relief period, the disaster coding should prevent the accrual of the Failure to File (FTF) penalty,[5] the Failure to Pay (FTP) penalty,[6] and interest on the account from the disaster period beginning date to the disaster period ending date. Otherwise, interest and penalties would be assessed and then later abated after it was determined that the taxpayer was affected by the disaster.

To provide additional assurance that affected taxpayers obtain the tax relief they are entitled to, the IRS provides information to taxpayers so they are aware they may qualify for relief. Notices included with mailings to taxpayers in the disaster areas instruct the taxpayers to contact the IRS if they are having difficulty meeting their income tax obligations due to the disaster. IRS employees are instructed to manually input the disaster coding for these taxpayers.

We limited our tests to individual taxpayer accounts because individuals are affected the most by natural disasters. Accordingly, we reviewed individual accounts coded for Presidentially declared disasters with disaster extensions that included April 16, 2001,[7] and for which the taxpayers filed late.

Responsibility for the IRS' Disaster Assistance Program was transferred from the Wage and Investment (W&I) Division to the Small Business/Self-Employed (SB/SE) Division in October 2001. We performed audit work from January through July 2003 in the SB/SE Division Headquarters in Washington, D.C.; the SB/SE Division Penalty and Interest Office in Ogden, Utah; and the W&I Division Headquarters in Atlanta, Georgia, in accordance with *Government Auditing Standards*. Detailed information

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[5] I.R.C. § 6651(a)(1) (2001), commonly referred to as the Failure to File penalty, is imposed when a taxpayer does not file his or her return by the due date, including any extensions.
[6] I.R.C. § 6651(a)(2) (2001), commonly referred to as the Failure to Pay penalty, is imposed when any tax due on a return is not paid by the due date of the return.
[7] April 15, 2001, fell on a Sunday, so the original filing due date was extended to Monday, April 16, 2001.

on our audit objective, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II. Details of the disasters included in our review are identified in Appendix V.

Many Taxpayers Affected by Natural Disasters Did Not Receive the Interest and Penalty Relief Intended by Management

To help protect taxpayers' rights and reduce the burden on affected taxpayers, IRS management developed a written policy to prevent the assessment of interest and penalties related to filing and payment extensions granted during the period immediately following the declaration of a Federal disaster area. However, many taxpayers residing in the Federal disaster areas we reviewed were not provided the disaster relief that IRS management intended. Specifically, the IRS did not always prevent or abate interest and penalties for these taxpayers.

We reviewed the accounts of 461 taxpayers, living in 7 Federal disaster areas, for which interest and/or penalties were assessed.[8] We determined that 109 taxpayer accounts contained various combinations of the following interest and penalty errors:

- For 107 of the 461 accounts,[9] taxpayers did not receive the interest and penalty relief they were entitled to because interest assessments or accruals totaling $13,766 had not been abated in accordance with I.R.C. § 6404(h). Based on the total population of 170,009 taxpayer accounts with assessments of interest and/or penalties that were coded for relief for the 7 disasters, we estimate that $5.1 million in interest was incorrectly assessed or accrued on 39,460 taxpayer accounts and should be abated.
- For 84 of the 461 taxpayer accounts,[10] there were inappropriate FTF and/or FTP penalties assessed and/or accrued, totaling $15,123. In each of these cases, the IRS had exercised its authority under I.R.C. §§ 6081 and

[8] Our sampling methodology is explained in Appendix I.
[9] In 1 of the 461 cases we reviewed, the taxpayer was assessed interest and penalties that were later abated. An IRS employee then manually reassessed the full amount of the interest and penalties.
[10] Eighty-two of these 84 accounts also incurred inappropriate interest assessments or accruals and are included in the 107 accounts previously identified. The remaining two accounts have inappropriate assessments of the FTF penalty only.

6161 to postpone the deadlines for filing tax returns and paying taxes for taxpayers who live in Federal disaster areas. Based on the previously mentioned total population of 170,009 taxpayer accounts, we estimate that $3.3 million in FTF penalties were inappropriately assessed for 11,063 taxpayer accounts, and $2.3 million in FTP penalties were inappropriately assessed or accrued for 28,765 taxpayer accounts.

Using incorrect disaster period dates resulted in erroneous interest and penalty assessments and accruals

We determined that interest and penalty assessments and accruals were not accurate because the incorrect disaster period beginning or ending dates were input. This occurred because the IRS Modernization, Information Technology and Security (MITS) Services computer programmers used the IRS disaster declaration memoranda to determine which dates to input; however, the memoranda[11] did not clearly identify the dates for which IRS management intended to suspend interest and penalties on taxpayers' accounts. As a result, the computer programmers input incorrect disaster period beginning or ending dates.

- In 77 of the 109 taxpayer accounts where disaster relief was not provided as intended, MITS Services programmers did not use the correct disaster period beginning dates. The disaster period beginning dates the programmers input to the computer systems were after April 16, 2001. As a result, IRS computers did not recognize that the taxpayers' original due dates for filing their returns and paying their taxes came after the beginning of the Federal disaster period. Therefore, the disaster coding on the accounts was ignored for the interest and penalty computations. These accounts contained $25,532 of inappropriate assessments or accruals of interest and/or penalties.

  Our comparison of the disaster declaration memoranda used to identify the applicable disaster relief periods and taxpayers' accounts showed that:

[11] The disaster declaration memoranda are addressed to all IRS employees and provide an overview of and guidance for the tax relief granted to taxpayers.

- For 74 of the 77 instances, the date the President declared the area a disaster for Federal assistance was used as the disaster period beginning date instead of the date that IRS management intended the disaster relief to start. As a result, the disaster period beginning date was later than it should have been.
- In the three other instances, the signature date of the IRS disaster declaration memorandum was used as the disaster period beginning date instead of the date on which IRS management intended the disaster relief to start. As a result, the disaster period beginning date was later than it should have been.

- In 1 of the 109 taxpayer accounts where disaster relief was not provided as intended, MITS Services programmers did not use the correct disaster period ending date. The ending date input was earlier than the date intended by management. As a result, the computer began the computations before the end of the disaster extension, and interest and penalties were inappropriately assessed on the account.

  IRS management did not have procedures to test cases to determine if the disaster programming worked as intended. MITS Services programmers advised that some time after the period covered by our review, they began informally requiring an e-mail from the National Disaster Assistance Program Manager that specifically details the disaster period beginning and ending dates that IRS management wants input for the disaster coding.

- In 15 of the 109 cases where disaster relief was not provided as intended, MITS Services programmers corrected the disaster period dates but did not recalculate interest and penalties or did not generate overpayments where the account was paid in full. These accounts contained $1,513 of inappropriate assessments or excess accruals of interest and/or penalties.

  In these cases, the disaster programming did not recalculate interest and penalties after inaccurate disaster period beginning and ending dates were corrected.

Initially, incorrect disaster period beginning and/or ending dates were input to the program, and an IRS field employee alerted the National Disaster Assistance Program Manager, who advised MITS Services programmers. Although corrections were made to the disaster coding on the accounts, both during and after the disaster period, MITS Services programmers advised that they did not initiate programming to recalculate the FTF penalty on taxpayer accounts with disaster coding errors until June 2002 and may not have recalculated interest and FTP penalties on the accounts when the dates were changed.

Some assessments and accruals were incorrect for reasons other than the input of incorrect disaster period dates

We determined that interest and penalty assessments were incorrect in other cases for other reasons:

- In 1 of the 109 cases, MITS Services programmers corrected the disaster dates, and the computer automatically abated all the interest and penalties. However, an IRS employee manually reassessed the improper interest and penalties on the account.
- In 3 of the 109 cases, the taxpayers paid the account balance or the account was otherwise cleared prior to the disaster programming being input to the accounts. After the programming was input, an overpayment was not generated on the account for the inappropriately assessed interest and/or penalties.
- In 12 of the 109 cases, MITS Services programmers corrected the disaster period dates prior to the taxpayers filing their returns and fully paying their accounts. While the indicators for the disaster (i.e., the disaster period beginning and ending dates and return due date) are correct on the accounts, interest and/or penalties were inappropriately assessed or accrued on these accounts. Neither we nor IRS management could determine why the programming did not prevent these assessments.

Recommendations

1. To prevent input errors in the future, the Deputy Director, Compliance Policy, SB/SE Division, should formalize the practice of providing MITS Services with the specific disaster period beginning and ending dates for input to the disaster program.

Management's Response: Since the Disaster Assistance and Emergency Relief Program was transferred to the SB/SE Division in October 2002, all disaster relief memoranda contain the specific beginning and ending dates for filing and payment relief and are distributed to each operating division, including MITS Services. These procedures have been added to the Internal Revenue Manual.

2. The Deputy Director, Compliance Policy, SB/SE Division, should develop procedures to test disaster programming output to ensure that the program is working as management intended.

Management's Response: SB/SE Division Disaster Assistance Program management advised that procedures to test the programming input were put in place in October 2002. The Disaster Assistance Program staff reviews the accuracy of the file created by MITS Services that contains the county name, zip code, and beginning and ending dates for filing and payment relief. SB/SE Division Disaster Assistance Program management will develop a process to test Master File output programming to ensure taxpayers are receiving the relief intended.[12]

3. For the seven disasters reviewed in this audit, the Director, Compliance, SB/SE Division, should identify taxpayer accounts where the disaster extension was intended but not provided. Appropriate action should be taken to abate or refund interest and penalties assessed

[12] The Master File is the IRS database that stores various types of taxpayer account information. This database includes individual, business, and employee plans and exempt organizations data.

on the accounts or to correct interest and penalty accruals on the accounts.

Management's Response: SB/SE Division Compliance function management has initiated steps to identify affected taxpayers for the seven disasters and plans to take actions to correct the taxpayers' accounts and issue refunds, if appropriate.

Appendix I

Detailed Objective, Scope, and Methodology

The overall objective of this review was to determine the effectiveness of Internal Revenue Service (IRS) actions to prevent or abate interest and penalty assessments for individual taxpayers granted filing and payment extensions in Presidentially declared disaster areas. To accomplish this objective, we performed the following work:

I. Identified actions taken by IRS management to prevent or abate interest and penalty assessments related to extensions granted to individual taxpayers located in Presidentially declared disaster areas.

   A. Interviewed IRS management and other responsible employees to identify the actions taken to prevent or abate interest and penalty assessments for the disaster extensions granted to individual taxpayers during the period January 1 through September 10, 2001. We determined whether the IRS input a systemic abatement of interest and penalties or took action to prevent interest and penalties from being assessed for each disaster with extensions including April 16, 2001.

   B. Obtained documentation of disaster extensions granted and actions taken to prevent and abate interest and penalty assessments related to the extensions.

II. Determined whether IRS actions effectively prevented or abated interest and penalty assessments related to extensions granted to individual taxpayers affected by Presidentially declared disaster areas.

   A. Reviewed individual taxpayer accounts from disasters meeting the criteria for application of Internal Revenue Code (I.R.C.) Section (§) 6404(h).[1]

      1. Identified seven Presidentially declared disasters for which the IRS granted extensions under I.R.C. §§ 6081 and 6161,[2] where the extension period included April 16, 2001, the due date for most Tax Year (TY) 2000 U.S. Individual Income Tax Returns (Form 1040).

      2. Reviewed a statistical sample of 461 individual taxpayer accounts from the population of 170,009 accounts with transaction codes (TC) 971 for the selected disasters,[3] where the taxpayer filed a TY 2000 return after April 16, 2001, and interest and/or penalties (Failure to Pay, Failure to File, and

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[1] I.R.C. § 6404(h) (2001).

[2] I.R.C. §§ 6081 (2001) and 6161 (2001).

[3] TC 971s with an Action Code of 086 or 087 and the Federal Emergency Management Agency (FEMA) Contract Number are posted to the entity portion of taxpayers' accounts for disaster processing. The FEMA Contract Number is unique for each disaster.

Estimated Tax Penalties) had been assessed for TY 2000. We selected a statistical sample of 455 accounts, using a 95 percent confidence level, a +/-2 percent precision, and an expected error rate not to exceed 5 percent. For two of the disasters in our sample, the random number generator did not select a minimum of five accounts. For these 2 disasters, we randomly selected an additional 6 accounts from the population designated for the 2 disasters to meet the minimum sample size; thus, our total sample size was 461 accounts. Statistical sampling was used because we wanted to estimate the number of taxpayer accounts in the population for which the interest and/or penalties were inappropriately assessed. We discussed our sampling methodology with an expert statistician, who provided the formulas used to project our sample results over the population.

B. Determined the cause of any inappropriate assessments of interest and penalties.

1. Determined if a programming or other error occurred.
2. Estimated the number of taxpayers affected by any programming errors or discrepancies and the amount of interest and penalty assessments made in error by statistically projecting the error rate identified from the sample across the universe of 170,009 taxpayer accounts with TC 971s for the selected disasters, where the taxpayer filed a TY 2000 return after April 16, 2001, and interest and/or penalties (Failure to Pay, Failure to File, and Estimated Tax Penalties) were assessed for TY 2000.

Appendix II

Major Contributors to This Report

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Appendix III

Report Distribution List

Commissioner C
Deputy Commissioner for Services and Enforcement SE
Director, Compliance, Small Business/Self-Employed Division SE:S:C
Deputy Director, Compliance Policy, Small Business/Self-Employed Division SE:S:C:CP
Director, External Stakeholders, Small Business/Self-Employed Division SE:S:C:CP:E
Director, Reporting Compliance, Small Business/Self-Employed Division SE:S:C:CP:RC
Director, Strategy and Finance, Wage and Investment Division SE:W:S
Chief, Information Technology Services OS:CIO:I
Chief Counsel CC
National Taxpayer Advocate TA
Director, Office of Legislative Affairs CL:LA
Director, Office of Program Evaluation and Risk Analysis RAS:O
Office of Management Controls OS:CFO:AR:M
Audit Liaisons:
Commissioner, Small Business/Self-Employed Division SE:S
Commissioner, Wage and Investment Division SE:W

Appendix IV

Outcome Measures

This appendix presents detailed information on the measurable impact that our recommended corrective actions will have on tax administration. This benefit will be incorporated into our Semiannual Report to the Congress.

Type and Value of Outcome Measure:

- Taxpayer Entitlements – Actual; we estimate that $5.1 million in interest was incorrectly assessed or accrued on 39,460 taxpayer accounts and should be abated. In addition, we estimate that $3.3 million in Failure to File (FTF) penalties were inappropriately assessed on 11,063 taxpayer accounts, and $2.3 million in Failure to Pay (FTP) penalties were inappropriately assessed or accrued on 28,765 taxpayer accounts (see page 3).

Methodology Used to Measure the Reported Benefit:

A computer download of limited account information was obtained from the Internal Revenue Service (IRS) Individual Master File (IMF)[1] for accounts where: 1) a Transaction Code (TC) 971 with an Action Code of 086 or 087 and a Federal Emergency Management Agency (FEMA) Code posted to the taxpayer's entity section[2] from January 1 through September 10, 2001, and 2) the taxpayer had a U.S. Individual Income Tax Return (Form 1040) posted to his or her Tax Year (TY) 2000 account. Through queries of these IMF data, we identified 170,009 individual taxpayer accounts with the disaster coding for the 7 disasters meeting the criteria for application of Internal Revenue Code (I.R.C.) Section (§) 6404(h),[3] where transaction codes for interest and the FTF, FTP, or Estimated Tax penalties[4] were posted to the account. We selected a valid statistical sample of 461 accounts, using an attribute sampling methodology and a 95 percent confidence level, a +/- 2 percent precision, and an expected error rate not to exceed 5 percent.

We reviewed the interest and penalty assessments on these 461 accounts to determine if the disaster extension period was excluded in any interest or penalty assessments. We used the Decision Modeling, Incorporated software to recalculate the assessments and compute any

[1] The IMF is the IRS' database that maintains transactions or records of individual tax accounts.
[2] TC 971s with an Action Code of 086 or 087 and the FEMA Contract Number are posted to the entity portion of taxpayers' accounts for disaster processing. The FEMA Contract Number is unique for each disaster.
[3] I.R.C. § 6404(h) (2001).
[4] Our sampling methodology included transaction codes related to Estimated Tax Penalties in identifying the population for our sampling. The disaster extension did not apply to any of the Estimated Tax Penalty assessments on the TY 2000 accounts in our sample; therefore, no errors are reported for this type of penalty.

inappropriate assessments and excess accruals on the accounts for the disaster extension periods.[5] We determined that:

- For 107 of the 461 accounts, there was $13,766 in inappropriate interest assessments or excess accruals.
- For 84 of the 461 taxpayer accounts, there were inappropriate FTF and/or FTP penalty assessments and accruals. Thirty taxpayers were inappropriately assessed FTF penalties totaling $6,158, and 78 taxpayers were inappropriately assessed or had excess accruals of FTP penalties totaling $8,965.[6] ($6,158 + $8,965 = $15,123)

We are 95 percent confident that in this population:

- Interest was inappropriately assessed and/or accrued on 39,460 taxpayer accounts (between 32,900 and 46,200), and the inappropriate interest assessments and accruals totaled approximately $5,134,272 (between $2,476,162 and $7,792,382).
- FTF penalties were inappropriately assessed on 11,063 taxpayer accounts (between 7,231 and 14,896), and the inappropriate assessments totaled approximately $3,306,675 (between $1,490,315 and $5,123,035).
- FTP penalties were inappropriately assessed and accrued on 28,765 taxpayer accounts (between 22,939 and 34,591), and the inappropriate assessments totaled approximately $2,271,320 (between $884,926 and $3,657,714).

[5] Decision Modeling, Incorporated software is used by the IRS' Small Business/Self-Employed Division's Penalty and Interest Office to compute manual assessments.
[6] The total number of taxpayers affected contains duplications, since some taxpayers had interest and one or both of the penalties assessed or accrued.

Appendix V

Presidentially Declared Disasters Included in This Review

Mississippi - Federal Emergency Management Agency Contract #1360:

On February 23, 2001, the President declared several Mississippi counties as Federal disaster areas due to damage as the result of tornadoes. The Internal Revenue Service (IRS) issued a declaration memorandum[1] and granted disaster victims in the designated areas an automatic extension to file returns and pay tax, as authorized by Internal Revenue Code (I.R.C.) Sections (§§) 6081 and 6161.[2] The extension was granted to June 15, 2001, for affected taxpayers whose Federal tax returns were due on or after February 16, 2001, and before June 15, 2001.

Washington - Federal Emergency Management Agency Contract #1361:

On March 1, 2001, the President declared several Washington counties as Federal disaster areas due to damage as the result of an earthquake occurring on February 28, 2001. The IRS issued a declaration memorandum on March 13, 2001, and granted disaster victims in the designated areas an automatic extension to file returns and pay tax, as authorized by I.R.C. §§ 6081 and 6161. The extension was granted to April 30, 2001, for affected taxpayers whose Federal tax returns were due on or after February 28, 2001, and before April 30, 2001. The same provisions also applied to counties later declared Presidential disaster areas in amended declarations for this disaster.

Iowa - Federal Emergency Management Agency Contract #1367:

On May 2, 2001, the President declared several Iowa counties as Federal disaster areas as the result of damage from severe storms, tornadoes, and flooding that started April 8, 2001. The IRS issued a declaration memorandum on May 9, 2001, and granted disaster victims in the designated areas an automatic extension to file returns and pay tax, as authorized by I.R.C. §§ 6081 and 6161. The extension was granted to August 15, 2001, for affected taxpayers whose Federal tax returns were due on or after April 8, 2001, and before August 15, 2001. The same provisions also applied to counties later declared Presidential disaster areas in amended declarations for this disaster.

Wisconsin - Federal Emergency Management Agency Contract #1369:

On May 11, 2001, the President declared several Wisconsin counties as Federal disaster areas as the result of damages caused by severe storms and flooding that started April 10, 2001. The IRS issued a declaration memorandum on May 23, 2001, and granted disaster victims in the

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[1] The archived document does not show a date of issuance.
[2] I.R.C. §§ 6081 (2001) and 6161 (2001).

designated areas an automatic extension to file returns and pay tax, as authorized by I.R.C. §§ 6081 and 6161. The extension was granted to August 15, 2001, for affected taxpayers whose Federal tax returns were due on or after April 10, 2001, and before August 15, 2001. The same provisions also applied to counties later declared Presidential disaster areas in amended declarations for this disaster.

Minnesota - Federal Emergency Management Agency Contract #1370:

On May 16, 2001, the President declared several Minnesota counties as Federal disaster areas as the result of damages caused by severe storms and flooding that started March 23, 2001. The IRS issued a declaration memorandum on May 23, 2001, and granted disaster victims in the designated areas an automatic extension to file returns and pay tax, as authorized by I.R.C. §§ 6081 and 6161. The extension was granted to August 15, 2001, for affected taxpayers whose Federal tax returns were due on or after March 23, 2001, and before August 15, 2001. The same provisions also applied to counties later declared Presidential disaster areas in amended declarations for this disaster.

Nebraska - Federal Emergency Management Agency Contract #1373:

On May 16, 2001, the President declared several Nebraska counties as Federal disaster areas as a result of damage caused by severe storms, tornadoes, and flooding that started April 10, 2001, and continued until April 23, 2001. The IRS issued a declaration memorandum on May 23, 2001, and granted disaster victims in the designated areas an automatic extension to file returns and pay tax, as authorized by I.R.C. §§ 6081 and 6161. The extension was granted to August 15, 2001, for affected taxpayers whose Federal tax returns were due on or after April 10, 2001, and before August 15, 2001. The same provisions applied to counties later declared Presidential disaster areas in amended declarations for this disaster.

South Dakota - Federal Emergency Management Agency Contract #1375:

On May 17, 2001, the President declared several South Dakota counties as Federal disaster areas as a result of damage caused by severe storms, ice jams, and flooding that started March 1, 2001, and continued until April 30, 2001. The IRS issued a declaration memorandum on May 23, 2001, and granted disaster victims in the designated areas an automatic extension to file returns and pay tax, as authorized by I.R.C. §§ 6081 and 6161. The extension was granted to August 15, 2001, for affected taxpayers whose Federal tax returns were due on or after March 1, 2001, and before August 15, 2001. The same provisions applied to counties later declared Presidential disaster areas in amended declarations for this disaster.

Appendix VI

Management's Response to the Draft Report

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

SMALL BUSINESS/SELF-EMPLOYED DIVISION

SEP 25 2003

MEMORANDUM FOR TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION

FROM: Dale F. Hart
Commissioner, Small Business/Self-Employed Division

SUBJECT: Draft Audit Report – Interest and Penalties for Taxpayers Affected by Natural Disasters Are Not Always Prevented or Abated (Audit # 200310009)

I have reviewed your draft report and agree with your recommendations. The goal of the Disaster Assistance and Emergency Relief Program is to provide assistance and reduce burden of taxpayers in disaster areas who have been granted filing and payment extensions.

We developed a computer application to identify taxpayers who reside in disaster areas based on their zip codes. Our systemic programming prevents interest and penalties from accruing, suppresses the issuance of certain notices, and places a disaster indicator on affected taxpayers' accounts during the disaster period. The purpose of the disaster indicator is to ensure that we do not take inappropriate actions against taxpayers affected by the disasters.

We have addressed the issues you cited in your report, and corrective actions have been or will be taken. One significant action is the development of Internal Revenue Manual (IRM) 25.16, Disaster Assistance and Emergency Relief Program. This IRM contains updated administrative guidance and operating procedures for responding to disasters or other significant emergencies. Additionally, we have procedures in place that ensure penalty and interest charges are suspended during the disaster period for all taxpayers affected by the disasters.

Our comments on your recommendations follow:

RECOMMENDATION 1

To prevent input errors in the future, the Deputy Director, Compliance Policy, Small Business/Self-Employed (SB/SE) Division, should formalize the practice of providing Modernization and Information Technology Services (MITS) with the specific disaster period beginning and ending dates for input to the disaster program.

CORRECTIVE ACTION

Since the Disaster Assistance and Emergency Relief Program was transferred to the Small Business/Self-Employed Division in October 2002, all disaster relief memorandums contain the specific beginning and ending dates for filing and payment relief. The relief memoranda are distributed to each operating division, including MITS. These procedures have been added to the IRM.

IMPLEMENTATION DATE

Completed

RESPONSIBLE OFFICIAL

N/A

CORRECTIVE ACTION MONITORING PLAN

N/A

RECOMMENDATION 2

The Deputy Director, Compliance Policy (SB/SE), management should develop procedures to test disaster programming output to ensure that the program is working as management intended.

CORRECTIVE ACTION

We have procedures in place to test the input programming. When MITS receives the disaster relief memorandum, it creates a file containing the county name, zip code, and beginning and ending dates for filing and payment relief. The file is posted to the Telephone Routing Interactive System (TRIS) web site and reviewed by the Disaster Assistance Program staff for accuracy. Errors are readily identified and corrected. The data elements from the TRIS file are then copied into the Master File disaster computer application program. These procedures were put in place in October 2002. We will develop a process to test the output programming to ensure taxpayers are receiving the relief intended.

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IMPLEMENTATION DATE

January 15, 2004

RESPONSIBLE OFFICIAL

Director, Reporting Compliance, Small Business/Self-Employed Division

CORRECTIVE ACTION MONITORING PLAN

The Program Manager, Disaster Assistance and Emergency Relief, will advise the Director, Reporting Compliance of corrective action delays

RECOMMENDATION 3

For the seven disasters reviewed in this audit, the Director, Compliance (SB/SE), should identify taxpayer accounts where the disaster extension was intended, but not provided. Appropriate action should be taken to abate or refund interest and penalties assessed on the accounts, or to correct interest and penalty accruals on the accounts.

CORRECTIVE ACTION

SB/SE Compliance submitted a "placeholder" Request for Information Services (RIS) to MITS on August 25, 2003. The RIS requests programming that will identify affected taxpayers and initiate actions to correct their accounts. We will issue refunds, if appropriate. A final RIS will be submitted to MITS by December 15, 2003. The RIS programming will be completed by December 31, 2005.

IMPLEMENTATION DATE

December 15, 2005

RESPONSIBLE OFFICIAL

Director, Reporting Compliance, Small Business/Self-Employed Division

CORRECTIVE ACTION MONITORING PLAN

The Program Manager, Disaster Assistance and Emergency Relief, will advise the Director, Reporting Compliance of corrective action delays.

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If you have any questions, please call me at (202) 622-0600 or Joseph R. Brimacombe, Deputy Director, Compliance Policy, Small Business/Self-Employed Division, at (202) 283-2200.